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NOTES

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Tyler J. Bowles
W. Cris Lewis*

Introduction

Measuring lost profits in commercial litigation is a common assignment for the forensic economist. Generally the forensic economist relies heavily on various financial statements. Financial statements make (both explicitly and implicitly) a number of assertions. When using financial statements in a lost-profit analysis, the appraiser is implicitly relying upon those assertions. There may be no assurance, limited assurance, or reasonable assurance that the financial statement assertions are correct. At a minimum, the lost profits appraiser ought to understand the level of assurance (if any) attached to the financial statements being used in the appraisal. The purpose of this paper is to discuss the financial statement assertions important in lost-profit appraisals and note the different levels of assurance recognized and provided by the accounting profession.

Relevant Financial Statement Assertions

A standard method used by economists to appraise lost profits (the before and after method) compares the plaintiff's profits prior to the alleged violation to profits subsequent to the violation (see Cerrillo 1989; Dunn 1992; and Plummer and McGowin 1993 for discussions of this method). Applying this method generally involves estimating lost revenue and then multiplying by the incremental profit margin (Plummer and McGowin 1993). A common technique used to calculate the incremental profit margin is to identify each expense category (using income statements or underlying adjusted trial balances[1]) as being variable or fixed.[2] The financial statement assertions being relied upon when using financial statements as a basis for applying the before and after method are, therefore, as follows:

1. Transactions reported actually occurred during the period covered.
2. There are no unreported transactions.
3. The company was actually a party to reported transactions.
4. Revenues and expenses were properly measured.

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[1] The standard income statement format generally will not provide the necessary detail to delineate variable and fixed costs. The underlying adjusted trial balance is more likely to provide the necessary detail.

[2] Linear regression provides an alternative technique for estimating the incremental profit margin. This technique obviates relying upon the financial statement assertion that expenses have been properly classified

5. Revenues and expenses are properly described and disclosed.

The question of present interest is what level of assurance should be attached to these assertions. The accounting profession provides for its members (certified public accountants) to be associated with financial statements on 3 different levels: compiled, reviewed, or audited financial statements. Reviews and audits are attestation engagements. An attestation engagement is one in which the CPA is engaged to issue a written communication that expresses a conclusion with respect to the reliability of a written assertion that is the responsibility of another party (AICPA, 1993 AT Section 100.01). A compilation is not an attestation engagement. Each type of association provides a different level of assurance concerning the financial statement assertions. What follows is a discussion of each type of association or engagement and the corresponding level of assurance being attested to by the certified public accountant.

Compilation

Professional standards prohibit a CPA from submitting "unaudited financial statements to [a client] or others unless, as a minimum, [the CPA] complies with the provisions of [the] statement applicable to a compilation engagement" (AICPA, 1993, AR §100.07). Because of this requirement and the fact that most small businesses have no need for audited or reviewed financial statements, compiled financial statements with the associated compilation report are common. Given this, how should the appraiser of lost profits view compiled financial statements?

Since a compilation is not an attestation engagement, the CPA does not express any conclusion about the assertions expressed in the financial statements and explicitly disclaims any level of assurance. The standard report issued in a compilation engagement is worded as follows (AICPA, 1993, AR §100.17):

> I (we) have compiled the accompanying balance sheet of XYZ Company as of December 31, 19xx, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.
>
> A compilation is limited to presenting in the form of financial statements information that is the representation of management (owners). I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.[3]

The disclaimer contained in the compilation report should be duly noted. As a

[3] A CPA does not have to be independent of the business entity to issue a compilation report. If the accountant is not independent, the compilation report needs to so indicate in an additional paragraph of the report

practical matter, however, the fact that a CPA has associated himself with the financial statements should give some comfort to the appraiser performing the lost-profit analysis. Although a CPA is not required to apply any substantive tests[4] or analytical procedures[5] in compilation engagements, professional standards do require the following (AICPA, 1993, AR §100.010—AR §100.13):

1. The accountant should possess a level of knowledge of the accounting principles and practices of the industry in which the entity operates.
2. The accountant should possess a general understanding of the nature of the entity's business transactions, the form of its accounting records, the stated qualifications of its accounting personnel, the accounting basis on which the financial statements are to be presented, and the form and context of the financial statements.
3. The accountant should determine whether it is necessary to perform other accounting services for the business entity.
4. The accountant should compile the financial statements before issuing a report.
5. If the accountant becomes aware that information supplied by the business is incorrect or incomplete, the accountant should obtain additional information.

Moreover, it is the authors'[6] opinion that many CPAs go beyond the required procedures for a compilation to reduce liability exposure (see Kisscorni and Klein, 1996).

Another important consideration when determining the usefulness of compiled financial statements is that generally the CPA performing the compilation also is providing bookkeeping services for the entity. Compiled financial statements are often produced as a by-product of the bookkeeping service. Hence, there is some likelihood that a reasonable chart of accounts has been established and expenses and revenues have been properly classified.

Reviews

As noted earlier, a review is an attestation engagement. Here, the accountant performs inquiry and analytical procedures sufficient to form "a reasonable basis for expressing limited assurance that there are no material modifications that should be made to the financial statements" (AICPA, 1993, AR §100.05). The standard report issued in a review engagement includes the following paragraph (AICPA, 1993, AR §100.35):

> Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them

[4] An example of a substantive test would be to confirm the reported cash balance with the bank.

[5] An example of an analytical procedure would be calculating the gross profit margin and comparing it to prior years' gross profit margins.

[6] The lead author is a licensed CPA with public accounting experience.

to be in conformity with generally accepted accounting principles.

Unlike a compilation, where no assurance is provided, a review provides negative assurance (i.e., we are not aware of . . .). Consequently, the CPA is required to make inquiries of management concerning some fundamental business practices and policies. The following list is indicative, but not exhaustive, of areas of inquiry: (1) the entity's accounting principles and practices and the methods followed in applying them; (2) the entity's procedures for recording, classifying, and summarizing transactions; and (3) actions taken at meetings of stockholders, board of directors, or comparable meetings that may affect the financial statements. Furthermore, the accountant must perform analytical procedures designed to identify relationships and individual items that appear to be unusual. For example, the CPA might calculate the current year's gross profit margin and compare it to prior years' gross profit margins. The accountant also must be independent of the entity.

Notwithstanding that a review is explicitly limited in scope, liability concerns and professional standards require CPAs to apply significant professional care in providing reviews. The most popular industry guide to conducting reviews for small businesses provides a very detailed checklist which is 42 pages long (PPC, 1995). Moreover, many CPAs have customized checklists and procedures to supplement those provided by PPC. It is the authors' opinion that the appraiser performing a lost-profit analysis can, in general, be quite comfortable with using reviewed financial statements.

Audits

A general definition of an audit is as follows (Auditing Concepts Committee, 1972, p. 18):

> A systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users.

Audits offer the highest degree of assurance available. The opinion paragraph of an audit report reads as follows (AICPA, 1993, AU §411.01):

> In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Company as of December 31, 19xx, and the results of its operations and its cash flows for the year then ended, in conformity with generally accepted accounting principles.

The standards and procedures which the certified public accountant must follow in audit engagements are designed to provide a reasonable assurance that no material misstatements exist in the financial statements. Given the liability exposure inherent in offering assurance on financial assertions and the independent quality reviews required of CPAs who perform audits, they generally are performed professionally and thoroughly. Consequently, the lost profits appraiser can feel comfortable in using audited financial

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statements as a starting point in an appraisal.

Summary and Conclusions

The appraiser of lost profits should be aware of the credibility of the financial statements used in the appraisal. The accounting profession provides for three levels of association that a certified public accountant may have with financial statements: a compilation, a review, or an audit. Professional standards require minimal procedures for a compilation, and the accountant explicitly disclaims any level of assurance. Analytical procedures must be applied when performing a review and a negative assurance is provided by the independent accountant. In performing an audit, the independent accountant is required to apply procedures sufficient to express positive assurance that the assertions embodied in the financial statements are accurate.

It is submitted that the lost-profits appraiser should use compiled financial statements with caution. However, that a CPA has been associated with them is important in judging their credibility. They generally are better than financial statements which have had no association with a CPA. The lost-profits appraiser can use reviewed financial statements with a moderate level of assurance that the financial assertions contained in them are accurate. Audited financial statements provide the user with the highest level of assurance.

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